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THE JAPANESE ECONOMY IN 1985

Summary

While overall growth of gross national product was not as high as the previous year, the Japanese economy continued to expand at a better pace than its U.S. counterpart in 1985. In addition, the pattern of growth was more even, as the economy moved from the recovery phase to the expansion stage.

Foreign demand was again responsible for nearly one-third of the economic stimulus, either directly via trade in goods or indirectly through investments by export-oriented firms. Domestic demand did improve over 1984's level, rising from 62 percent to 71 percent of overall growth. Japan enjoyed a record trade surplus and a long-term capital deficit for the second year in a row, eliciting a mixed response from its trading partners. Tokyo sought non-Keynesian remedies with greater energy but less success.

Overview of GNP Growth

Japan's gross national product grew a solid inflation-adjusted 4.6 percent in 1985, a decline from the previous year's 5.1 percent that can be ascribed to the slowing growth of exports (see Table 1). The performance precisely matched the government's initial estimates for FY 1985 made in late 1984, although lower-than-expected third quarter growth caused some concern. Japanese officials were not displeased with the economy's performance, which they asserted represented a shift from recovery to expansion.

This observation is borne out by the fact that all but one of the components of GNP made a positive showing. More importantly, residential housing demand revived (exceeding the Economic Planning Agency's 3.1 percent forecast for FY 1985), while business investment grew even faster than the planning agency's projected 8.5 percent rate. The EPA was disappointed, however, by stagnant consumer spending. The agency had originally hoped for 4.1 percent growth in this largest component of GNP during the April 1985-March 1986 period, but after a good start in the first quarter, expansion fell to just half of the expected rate.

EPA was also unpleasantly surprised to see its estimates of current account and trade account balances turn out to be off the mark. Instead of a trade surplus of approximately $44 billion and a current account surplus of $34 billion, Japan rang up balances of $56 billion and $49 billion, respectively. Although the growth of exports was only about one-third of 1984's rate, import expansion nearly came to a halt, resulting in 30 percent-plus growth in the net external sector.

The quarterly growth record was as erratic in 1985 as it had been in the previous 12 months, changing by more than 50 percent each period. Much of the unevenness can be traced to the seasonal pattern of foreign trade and residential construction, but private investment also played a role as it surged in the second quarter before settling down at a still fast pace for the remainder of the year.

Personal Consumption - Japanese consumers remained tight-fisted during 1985; growth held steady at just above 2 percent for most of the year. Only the first quarter's 4.8 percent showing prevented 1985's overall expansion rate from falling more than 0.1 percentage point from the previous year. When the final three quarters are factored in, consumer spending as a share of GNP fell for the second consecutive year from 56.9 percent to 55.8 percent.

This trend vexed policymakers since consumers again failed to respond to positive developments. As in 1984, average wage and semiannual bonuses increased 4.5 percent; overtime hours were up; second incomes rose an average 2.8 percent; and disposable income grew a solid 4 percent. Although this last gain was less than 1984's 4.4 percent expansion, inflation was slightly lower in 1985 at 2.1 percent, meaning that the growth of real disposable income was fairly close in both years -- 1.9 percent last year versus 2.2 percent.

The situation is even more puzzling when average household spending is analyzed. Of the Y14,340 ($84.35 at Y170=$1.00) nominal increase in monthly disposable income, 6.6 percent was spent on clothing; 5 percent on increased transportation costs; 4.9 percent on food; 4.5 percent on recreation, 3.4 percent on furniture; 3 percent on education; 1.4 percent on housing costs; 0.6 percent on utilities; and 18.3 percent on miscellaneous expenditures. When compared with 1984's data (see JEI Report No. 16A, April 26, 1985), these increases are all significantly smaller. This reduction in the average household rate of spending growth meant that more money was saved. And indeed, savings accounted for a whopping 46.8 percent of the increase in disposable income, compared with 1984's share of just 0.4 percent.

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Table 1: Japan's Real Gross National Product at Constant (1980) Prices

(in billions of yen, seasonally adjusted, quarterly totals and rates of growth at annual rates)

	1984	1985	January-March 1985	April-June 1985	July-September 1985	October-December 1985
Gross National Product	Y278,118.6 (5.1%)	Y291,039.3 (4.6%)	Y285,425.7 (1.7%)	Y289,447.6 (5.8%)	Y291,588.4 (3.0%)	Y296,667.1 (7.2%)
Personal Consumption Spending	158,124.5 (2.8%)	162,439.9 (2.7%)	161,106.4 (4.8%)	161,900.4 (2.0%)	162,777.8 (2.2%)	163,650.2 (2.2%)
Private Residential Construction	13,619.1 (-2.1%)	14,056.2 (3.2%)	13,913.9 (5.1%)	14,227.9 (9.3%)	13,881.0 (-9.4%)	14,186.5 (9.1%)
Private Fixed Nonresidential Investment	46,277.4 (10.9%)	52,114.8 (12.6%)	48,574.5 (1.0%)	51,124.5 (22.7%)	53,189.7 (17.2%)	55,300.4 (16.8%)
Change in Business Inventories	1,609.6 (102.3%)	1,812.7 (12.6%)	2,112.0 (37.4%)	1,825.3 (-44.2%)	1,438.2 (-61.4%)	1,882.1 (193.3%)
Government Current Expenditures	26,471.3 (2.5%)	27,146.9 (2.6%)	26,979.1 (4.6%)	27,081.5 (1.5%)	27,192.9 (1.7%)	27,342.9 (2.2%)
Government Fixed Investment	22,374.4 (-2.9%)	20,831.2 (-6.9%)	21,615.5 (-7.1%)	19,954.0 (-27.4%)	20,495.6 (11.3%)	20,917.3 (8.5%)
Change in Government Inventories	162.8 (*)	305.9 (*)	27.9 (*)	77.6 (*)	515.6 (*)	604.7 (*)
Net External Sector	9,479.7 (59.3%)	12,331.7 (30.1%)	11,096.4 (-29.2%)	13,256.4 (103.7%)	12,097.6 (-30.6%)	12,783.0 (24.7%)
Exports of Goods and Services and Factor Income Received	52,365.0 (17.5%)	55,446.5 (5.9%)	54,833.7 (-3.0%)	57,176.9 (18.2%)	55,077.6 (-13.9%)	54,654.4 (-3.0%)
Imports of Goods and Services and Factor Income Paid	42,885.3 (11.1%)	43,114.9 (0.5%)	43,737.3 (5.5%)	43,920.5 (1.7%)	42,980.0 (-8.3%)	41,871.4 (-9.9%)

*Cannot be calculated or meaningless.

Note: Beginning with third quarter figures, real growth rates are expressed in terms of 1980 yen rather than 1975 yen. The accounting change is a normal updating procedure, and has the effect of reducing 1981-1984 overall real GNP growth rates to 3.3 percent, 3.2 percent, 3.7 percent and 5.0 percent, respectively.

Source: Economic Planning Agency

As a consequence, gross savings rose to an average of 22.5 percent of nominal disposable income, compared with 1984's 21.3 percent mark. The remainder was distributed among basic needs (housing, 3.7 percent; food, 19.9 percent; utilities, 4.6 percent; transportation, 7.5 percent; medical expenses, 1.8 percent; education, 3.3 percent) and discretionary expenses (furniture, 3.3 percent; clothing, 5.4 percent; recreation, 6.8 percent; miscellaneous expenses, 21.3 percent), virtually all below the previous year. It is obvious to Japanese officials that they have not yet found the right combination of incentives to induce consumers to open their pocketbooks.

Private Residential Construction - The housing industry continued the upswing that began in the second half of 1984 with a 3.2 percent showing, its best contribution since 1978. Despite a dip in the third quarter, 1,236,072 new housing units were started, a 4.1 percent gain. The average floor area of each new residential unit shrank to 83.4 square meters from 84.4, but the average price of a unit rose a shocking 34.5 percent. The number of rental units started (527,042) exceeded the number of new units for sale (464,697) for the first time in 1985, perhaps reflecting the sharp price increase.

In response to this trend and to stimulate the domestic economy, Tokyo in October increased the number of low-interest mortgages issued by the semi-public Housing Loan Corp. by 20,000 to a total of 510,000 for fiscal 1985. In addition, the government accelerated auctions of its land holdings in urban areas to stimulate new construction. Falling interest rates are likely to add to this stimulus, further brightening the outlook for 1986.

Private Nonresidential Investment - Capital investment continued to boom in 1985, putting in a second consecutive year of double-digit real growth. The contrast between the first and second quarters of 1985 is particularly stark: the annualized rate jumped from 1 percent to almost 23 percent. The sustained high rate of investment in the latter half of the year proves that the second quarter was not a fluke.

On a sectoral basis it appears that some of 1984's hot performers cooled off, and instead investment growth was distributed throughout the economy (see Table 2). Investment by firms in the electronics, nonelectric machinery and glass and ceramics sectors slowed dramatically from year-earlier rates. On the other hand, capital spending by automotive makers, chemical producers and service companies experienced strong upturns. Rationalization in the wood, paper and shipbuilding industries continued at a high rate.

Change in Inventories - The erratic behavior in inventory changes reflected continued vigorous production and shipment activities. Following the usual pattern during a recovery, inventories were drawn down in the summer and fall to meet rising holiday orders and rebuilt during the winter and spring months. With all industries operating at 102.2 percent of 1980 capacity levels, the large quarterly changes were understandable.

Public Sector - For the fourth year, the government's contribution to economic growth was negligible. The 4.6 percent bulge in outlays in the first quarter resulted from the supplemental budget passed in December. (The first quarter of calendar 1985 was the last quarter of fiscal 1984.) The true impact of Prime Minister Yasuhiro Nakasone's fiscal austerity policy was obvious from

Table 2: Capital Investment by Sector, FY 1984-FY 1985

(in billions of yen; percentage change)

	FY 1984 (Actual)		FY 1985 (Estimated)	
All Industries	Y21,928.0	11.6%	Y23,910.3	9.0%
All Manufacturing	9,887.0	18.3	10,706.4	8.3
Foods	583.7	-1.0	603.3	3.4
Textiles	196.1	30.2	201.0	2.5
Paper and Pulp	368.3	88.8	445.0	20.8
Chemicals	1,281.5	4.0	1,438.0	12.2
Oil and Coal	274.9	-1.8	298.4	8.5
Rubber and Leather	161.2	40.3	181.2	12.5
Ceramics	412.2	34.5	446.2	8.2
Steel	809.2	-16.1	840.5	3.9
Nonferrous Metals	290.0	34.7	336.5	16.0
Metal Products	280.3	7.6	295.1	5.3
Nonelectric Machinery	535.8	25.5	576.2	7.5
Electric Machinery	2,552.2	47.9	2,397.7	-6.1
Transportation Machinery	1,258.8	-2.2	1,703.1	35.3
Automobiles	954.5	5.0	1,363.9	42.9
Ships	55.9	-10.2	62.4	11.7
Other	248.4	43.5	276.8	11.4
Precision Machinery	286.0	16.6	335.4	17.3
Printing and Publishing	314.4	10.7	323.7	3.0
Other Manufacturing	282.3	26.5	285.0	1.0
All Non-manufacturing	12,041.1	6.6	13,203.9	9.7
Agriculture	25.3	-31.8	35.1	39.0
Mining	231.7	-5.7	173.4	-25.2
Construction	318.8	-4.0	286.4	-10.2
Wholesaling and Retailing	1,267.3	14.6	1,352.3	6.7
Wholesaling	608.5	12.9	615.7	1.2
Large Retailers	264.1	-11.2	301.7	14.2
Other Retailers	394.7	46.5	434.9	10.2
Finance and Insurance	571.4	10.2	575.4	0.7
Real Estate	1,006.1	15.0	1,150.0	14.3
Transportation and Communications	1,407.5	1.1	1,613.7	14.6
Private Railways	321.0	12.4	360.3	12.3
Ground Transportation	330.8	2.5	441.0	33.3
Shipping	319.1	-14.4	287.2	-10.0
Other	436.7	6.3	525.2	20.3
Electric Power	3,043.5	-8.6	3,104.2	2.0
Gas	269.1	-5.4	309.8	15.1
Services	925.8	12.0	1,174.0	26.8
Leasing	2,974.6	26.7	3,429.7	15.3

Source: Economic Planning Agency

the meager showing in the remaining nine months of 1985 -- the growth of current outlays hovered around 2 percent, while fixed investment fell below the level it had recorded earlier in the year -- a drop attributable to Mr. Nakasone's efforts to balance the national budget. The Ministry of Finance, with the prime minister's support, continued to slash spending for public works and other big-ticket items in the fiscal 1985 budget. Although Mr. Nakasone is justly proud of this feat of fiscal restraint, the economic consequences have grown increasingly clear and political pressures to reverse this policy have continued to grow.

External Sector - Since the net external sector component is a residual of exports less imports, volatile activity is the norm. While 1985's overall rate of increase of 30.1 percent was hardly torpid, it was only half of 1984's blistering pace. The strong net change, however, masked a distinct softening of export growth and nearly zero growth of imports. Taken together, trade directly accounted for just above one percentage point of overall GNP growth.

Beginning in mid-1985, the strengthening yen contributed to the slower growth of exports, while a strong currency plus weak commodity prices accounted for some of the decline in the value of imports. Exports of individual products remained strong, including motor vehicles, video cassette recorders and other consumer electronics, as the expansion in the United States and the recovery in Europe continued. On the import side, purchases of crude oil and other basic inputs as well as intermediate goods rose in volume to meet investment and export demands.

Labor and Inflation

Japan's rate of unemployment declined slightly to 2.6 percent from the "high" of 2.7 percent suffered in 1984. While this level would be considered low in other industrialized nations, Tokyo was concerned over the increasing volatility of the jobless rate, which went up to 3 percent in March. Indeed, the rate dropped to 2.4 percent by July and then rose again to 2.7 percent in November. (Continuing this erratic behavior, it registered 3.1 percent in March of this year.)

Some analysts attributed this instability to the increasing use of part-time workers. While the proportion of temporary to full-time employees was up just two-tenths of a percentage point in 1985 (from 8.1 percent to 8.3 percent), the growth of part-timers continued to outstrip that of regular employees. The upward trend, however, is not out of line with changes in previous years.

Japanese workers again scored impressive gains in productivity as output per worker in the manufacturing sector rose 4.2 percent. Machinery makers contributed the biggest gain (up 7.8 percent), led by precision machinery workers (up 17.1 percent) and electrical machinery laborers (up 10.2 percent). Workers in the steel, metal products, lumber and paper industries also registered productivity gains of 4 percent or more, but this was mostly due to equipment modernization and labor rationalization cuts.

The wage picture was somewhat more controversial, for while the overall nominal wage index kept pace with productivity gains, the average real wage index again made little progress. On an industry-by-industry basis it was even

clearer that workers who exhibited greater productivity growth did not necessarily benefit more than those with lower growth. Wage indices for workers in the electrical machinery and precision equipment fields, for example, showed significantly less growth than the corresponding productivity indices. The opposite situation existed for steel, mining and shipbuilding employees. This mismatch posed problems not only for labor unions but also for the government. In fact, the credibility of labor leaders has come under severe strain as they again failed to win wage hikes commensurate with productivity gains and corporate profits. The government found itself in a difficult position: it hoped that fat wage increases would be negotiated to spur domestic demand, but not so high as to threaten the nation's international competitiveness.

Inflation continued at a modest 2.1 percent pace in 1985, down slightly from 1984's 2.2 percent rate. While medical costs, educational expenses and clothing prices were up fairly strongly, food costs, which represent nearly two-fifths of the consumer price index, rose just 1.7 percent. Also helping to keep inflation in check were the limited (2.1 percent) increases in the costs of transportation and recreation -- the index's second-largest components, as well a dip in utility bills. Wholesale prices were kept solidly under wraps in 1985, actually declining 1.1 percent after dropping 0.3 percent the year before. Cheaper prices for steel, nonferrous metals, electric machinery, transportation equipment, chemicals, paper and textiles all helped turn back the clock on wholesale prices for the third year in a row.

The yen-based export price index for all commodities fell 1.4 percent, as the average price of every category fell -- except transportation equipment, which had a tiny gain of 0.3 percent. Exporters were clearly doing their best to maintain a competitive position in the face of a rising yen. Import prices showed a 2.5 percent across-the-board decline, except for (oddly enough) energy prices. Price cuts were very deep, ranging from 2.3 percent on machinery and equipment to 9.8 percent on food products. Energy prices failed to drop because of unusually high demand in winter and spring, but then steadily declined for the rest of the year.

Production and Profits

Industrial production indices underscored the strength of the expansion in 1985, with the majority of industries registering increased output. In the manufacturing sector, where production expanded 4.6 percent, electrical machinery led the way with a 11.3 percent gain. Other big gainers spanned precision equipment (16.9 percent), nonelectrical machinery (7.3 percent), transportation equipment (3.6 percent) and chemicals (3.3 percent). Industries experiencing declines included petroleum and coal (off 5 percent), lumber (2 percent), textiles (0.7 percent) and nonferrous metals (0.4 percent). In terms of types of products, capital goods rose 8.6 percent, producer goods were up 3.4 percent and consumer goods rose 5 percent (durables up 8.1 percent and non-durables gaining 2.7 percent).

Because of the varying accounting years followed by companies, the profit picture was more vague. According to Ministry of Finance projections, however, manufacturing firms showed an average 2.8 percent increase in sales for fiscal 1985, but suffered a 12.3 percent drop in earnings for the period because of a very poor second half (an assumption based on the effects of the

stronger yen). Non-manufacturing companies fared a little better, according to the MOF forecast, with sales rising 6.1 percent and earnings also up 10.2 percent.

Monetary Policy

In the Finance Ministry, 1985 was another year of outward calm and inward turmoil. The Bank of Japan held a steady course on interest rates by keeping its discount rate pegged at 5 percent, and all interest rates linked to this figure, such as interest paid on small deposits and loan rates, remained steady. In this sense, monetary policy seemed to be governed by "business as usual."

The growth of the money supply (M2 + CDs) was well-behaved for three-fourths of the year, but began to expand unexpectedly beginning in October. Whereas in previous months the basic money pool had grown at 7.9 percent to 8.3 percent a month, it advanced by 8.6 percent, 9.1 percent and 9.3 percent, respectively, during the final months of 1985. This pace outstripped nominal GNP growth, putting upward pressure on prices. While inflation remained under control, BOJ officials were known to be nervous since the high money supply growth has continued into 1986. Because of the slowing economy, the central bank is loath to tighten up on the money supply and may even be forced to cut its discount rate for a fourth time in a single year. If the interest rate cut should reignite inflation instead of growth, Japan will be faced with stagflation.

In addition to this well-understood problem, financial policymakers faced many unknowns as they proceeded with the financial market deregulation program last year. It is not surprising that government agencies disagreed about plans to fundamentally change the structure of the nation's financial system. The battles fought over liberalization in 1985 revealed three factions: first, MOF internationalists anxious to bring Japan's system up to par with London and New York to compete effectively in international finance; second, BOJ and Tax Bureau officials favor who favored liberalizations, but reacted defensively about changes that would impair their ability to conduct monetary policy or collect levies; and third, the Ministry of Posts and Telecommunications, which was surprisingly vocal in defending its Postal Savings and Life Insurance and Annuity systems. (This is an understandable attitude as these accounts have assets of Y91 trillion ($535 billion) and Y28 trillion ($165 billion), respectively.) Despite this impressive opposition, MOF deregulators pushed through several important changes in 1985.

- Effective January 30, the withholding tax on interest from Euroyen instruments owned by foreigners was repealed. After heavy pressure from Washington and European capitals, MOF agreed to forego this revenue source in order to increase the attractiveness of Euroyen issues.

- Effective March 15, banks were permitted to sell money market certificates in minimum denominations of Y100 million ($588,000).

- Effective April 1, a short-term government bond market was inaugurated. To facilitate the refinancing of the large national debt, MOF issued Y500 billion ($2.9 billion) worth of short-term bonds during fiscal 1985 in

minimum denominations of Y100 million ($588,000). Initially, securities companies were not allowed to participate in short-term bond trading.

Several other changes went into effect at the same time:

- The minimum denomination of certificates of deposit and money market certificates was reduced to Y100 million ($588,000) and Y50 million ($294,000), respectively.

- Foreign subsidiaries or branches of Japanese companies were allowed to issue Euroyen instruments with maturities longer than one year. The minimum credit rating necessary for Euroyen issuers was also reduced from AA to A.

- Effective June 1, under new guidelines for overseas banking, off-balance-sheet items had to be reported; foreign liabilities were limited to 14 times shareholders' equity; limits were set on high-risk loans; the loan growth ceiling was raised to 20 percent annually; the ceiling on lending or borrowing in foreign currencies was eliminated; limits on the amount of loans to a single country were raised or eliminated; and participation in international loan syndicates was liberalized. On the same day:

- A bankers' acceptances market was established to facilitate trade finance and improve bank liquidity. First-day trading in short-term trade bills totaled a respectable Y72.1 billion ($424 million).

- An additional 50 banks were authorized to trade in outstanding government bonds, bringing the total to 87; bonds of all maturities were tradable for the first time.

- Securities houses were authorized to trade certificates of deposit, joining the 13 banks given permission in March.

- Effective September 10, the Bank of Japan liberalized interest rates paid on time deposits of Y1 billion ($5.9 million) or greater with terms of three months of more. This was the initial step in MOF's plan to liberalize deposit rates.

- Effective October 15, a bond futures market was inaugurated to help smooth the refinancing of the deficit and assist the transition to the heavier use of short-term bonds. After some initial success, the market, made up mainly of large banks, was devastated by the BOJ's interest rate cuts.

Other actions also opened Japan's financial markets to international influence. In July MOF announced that it would admit eight foreign banks to Japan's trust banking market, removing a source of friction with its trading partners. In September the Tokyo Stock Exchange voted to increase its associate membership by 10 seats and give associate members the same rights as full members in critical areas. As a result, Merrill Lynch & Co. and Morgan Stanley & Co. won associate memberships along with four other foreign brokers, eliminating another sore point. Tokyo's July 30 market liberalization "action program" also included commitments and timetables to deregulate several other areas (see JEI Report No. 31B, August 16, 1985).

All this activity had an unsurprising effect on Japan's long-term capital payments balance. A record deficit of $64.5 billion accumulated in 1985, continuing the huge net outflows begun in 1984 (see JEI Report No. 5B, February 7, 1986). A great deal of the capital came to this country, helping to finance the U.S. government's tremendous borrowing needs. In effect, the two financial systems have become increasingly interdependent, posing problems for the conduct of monetary policy.

Indirectly, therefore, the yen-dollar exchange rate was also heavily influenced by MOF's financial liberalization drive. As measured by the daily median rate on the Tokyo interbank spot market, the yen averaged Y254.18=$1.00 in January 1985. After falling slightly to Y260.24 in February, the yen began a steady upward drive against the greenback. In September, when the finance ministers of the United States, United Kingdom, West Germany, France and Japan met, the yen had already gained 6.8 percent against the dollar and stood at Y236.95. When the Group of Five agreed to lead the dollar lower against the yen and the West German mark, markets reacted strongly. The dollar bought an average of just Y202.83 in December, a 20.2 percent drop from the beginning of the year. It appeared that the yen internationalization/market deregulation program was beginning to pay off. The yen seemed to more truly reflect the relative strength of the Japanese economy, but the rapid appreciation began to worry Japanese officials.

Fiscal Policy

In a continuing effort to balance the budget, the government clamped the same tight lid on discretionary spending in FY 1985 as in the three previous fiscal years. A strict policy prevailed despite intense debate over the wisdom of austerity. Not only was the prime minister pressured by Diet members whose districts rely heavily on government spending, but he was also attacked by party rivals seeking to position themselves for the premiership. Kiichi Miyazawa, a dark horse in the race, proposed an ambitious "asset doubling" plan modeled after the highly successful "income doubling" drive of the 1960s. Mr. Miyazawa called for greatly expanded government spending on social infrastructure, such as parks, sewers, housing and roads, to bring Japan's standard of living up to the level of its Western counterparts. Mr. Nakasone, on the other hand, had made fiscal reconstruction one of the hallmarks of his administration and refused to back down. The fiscal 1985 budget clearly bore his imprimatur.

The 3.7 percent rise in FY 1985 overall general account outlays gives a false impression of growth, since it was due to an 11.7 percent increase in debt service costs and a 9 percent rise in transfers to local governments, both mandatory outlays. Discretionary spending was actually cut by Y263.2 billion ($1.5 billion), as the budget ax fell on pensions (-1.2 percent), public works (-2.3 percent), small business measures (-5.7 percent), and agricultural price supports (-14.5 percent). On the other hand, the prime minister continued to expand areas of interest, including social security (2.7 percent), education and science (0.2 percent), defense (6.9 percent), economic cooperation (7.8 percent) and energy measures (4.2 percent).

Business bore the brunt of FY 1985's special taxation measures, as MOF reduced the deductible for bad debts and eliminated the deferral of taxes for companies experiencing operating losses (see JEI Report No. 20A, May 24, 1985).

Even government and non-profit corporations were hit by rising tax rates. At the same time, though, MOF instituted a tax credit for research and development costs and investment in state-of-the-art equipment. But the net overall effect was an increase in revenues of Y316 billion ($1.9 billion).

The Fiscal Investment and Loan program, a self-funding second budget, actually declined 1.2 percent in FY 1985. All programs except for water works, disaster prevention, roads and regional development were cut by up to 13.9 percent. This was the first time in postwar history that the FILP had been reduced, and reflected Mr. Nakasone's decision to cut back on all types of government borrowing, even that intended for specific public works projects.

The FY 1985 supplemental budget, approved in December, was also a modest Y723 billion ($4.3 billion). The supplement was devoted mainly to disaster relief, a pay hike for government employees and increased funding for the Housing and Urban Development Corp. The fact that the budget was significantly less than FY 1984's Y886 billion ($5.2 billion) level was another indication of just how hard spending was being squeezed.

Given this state of affairs, it was not surprising that the public sector failed to make a positive contribution to last year's GNP growth. As the yen began to rise rapidly during the last quarter of 1985, policymakers grew increasingly concerned that fiscal austerity would trigger an economic slowdown. Nevertheless, the prime minister and the Ministry of Finance have resisted a return to pork-barrel politics. Instead, they have sought to promote private investment activity in housing and other large construction projects. Critics contend that this scheme will have little impact, but they have been unable to provide convincing alternatives.

With the opposition confused, Mr. Nakasone was also able to push ahead with his administrative reform program. The privatization of Nippon Telegraph and Telephone Public Corp. and Japan Tobacco and Salt Public Corp. on April 1, 1985 led to a boom in the domestic telecommunications market and provided better access to Japan's market for foreign tobacco product makers. Although the impact on government accounts was minimal (since the government maintains control of both entities), the move will eventually make government smaller by removing these two organizations from government balance sheets. Mr. Nakasone also moved in earnest to privatize the last major public corporation, Japanese National Railways. Because of its large excess employment problems, however, JNR reform proved to be a very sensitive issue. Nevertheless, preliminary steps were taken to push JNR out of the government's nest by 1987.

Conclusion

Although Japan's economy performed well in 1985, problems that were hidden during 1984's recovery came to the surface. The nation's sensitivity to foreign trade was paralleled by a new sensitivity to international financial forces. Japan's trade surplus grew so large as to invite comparisons with the surplus accumulated by members of the Organization of Petroleum Exporting Countries in the 1970s. At the same time, however, Japan realized that it was necessary to actively recycle this surplus through financial markets to prevent an international liquidity crisis. This did not insulate Tokyo from the harsh

criticism of its trading partners. Although Tokyo continued to stress non-fiscal means of stimulating the domestic economy, it did agree to cooperate in an effort to lower the dollar against the yen. The failure of the former and the success of the latter put the Japanese economy in an precarious position by the end of 1985.

For further information, contact Jon Choy.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.